Behavioral Finance 2.0—It's Not All Bad Behavior

Personal finance is more personal than it is finance.

The fields of behavioral finance and economics have been around for decades. They represent bodies of knowledge that have been applied, for better and for worse, by many. But they're only now entering the mainstream. The oversimplified lesson could be summarized as the following: You're all a bunch of irrational dummies. But at least one prominent behavioral financier thinks that's the wrong message.

I asked Dr. Meir Statman, the Glenn Klimek Professor of Finance at Santa Clara University, Is the rational/irrational dichotomy that seems to mark behavioral finance an oversimplification?

He answered with a resounding, "Absolutely!"

A Little Background

Let me back up a moment to offer some context. When the field of behavioral finance emerged, it turned hundreds of years of traditional theory on its head. Traditional theories presumed that we humans were rational actors in financial matters; that given a choice between improving ourselves financially or hurting ourselves financially, we'd always choose the former.

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Behavioral finance, then, told us what we've known in the back of our minds for millennia—that presuming we're always rational is a bunch of balderdash. But the interpretation of behavioral finance 1.0 seems to have concluded that quite often, if not the majority of the time, we fall prey to a host of cognitive biases that seemingly destine us to faulty financial decision-making. We're all a bunch of unevolved, irrational knuckleheads, it would seem.

That's what Dr. Statman would like to refute. He submits the second generation of behavioral finance drops the "rational" and "irrational" dichotomy and describes us—investors, specifically, and humanity in general—as simply "normal," and more complex than the dualistic lens would suggest.

“[W]e want freedom from poverty through steady income, prospects for riches in houses of our own, nurturing our children, helping family and friends, and being helped by them,” Dr. Statman writes in his book, *Behavioral Finance: The Second Generation*, available as a free download through the CFA Institute Research Foundation. He continues that we “use shortcuts and sometimes commit errors on our way to satisfying our wants. And we…are usually normal-knowledgeable and normal-smart but sometimes normal-ignorant or normal-foolish.”

Why It Matters

Here’s why the distinction matters. The oversimplified behavioral finance 1.0 narrative is being used as a weapon to bludgeon us as investors into believing that we’re just a giant animated blob of cognitive stupidity, that we only act on impulse or emotion, and that emotion is inherently bad. The second generation of behavioral finance doesn’t necessarily negate the brilliance of the first—it just frees it from the either/or trap.

And haven’t we all had just about enough of the two-sided doctrinal oversimplification of humanity these days?

As Oliver Wendell Holmes said of oversimplification: “For the simplicity on this side of complexity, I wouldn’t give you a fig. But for the simplicity on the other side of complexity, for that I would give you anything I have.” (Carl Richards simplified this quote beautifully in this drawing.)

Simply put, we’re more complex. And entirely normal. Here’s a new way to look at it.

A Three-Lens Approach To Financial Decisions

Both traditional finance and the first generation of behavioral finance boiled everything down to the single lens of utility. Through a utilitarian lens, you're either a winner or a loser, financially speaking. You're rational if you're a winner (rarely) and irrational if you're a loser (often). Let's look at an example, in the form of luxury automobile transportation:

From a utilitarian perspective—at least in any year other than 2021—the purchase of a new luxury vehicle makes one a big loser, right? You spend a ton of money on a quickly depreciating asset. You get lambasted by a loud-mouth personal finance "guru" as stupid and are relegated to the overpopulated island of irrationality.

And from a utilitarian perspective, yes, you're out a good chunk of change. But there are two other lenses through which to consider this decision—expressive and emotional.

From an *expressive* perspective, you're saying something about yourself through your choice of automobile, aren't you? My friend who has the new performance-edition Tesla TSLA -0.3% sends a message when he pulls his phone out and summons the vehicle to him like a well-trained dog. So too does our buddy who has a beautiful new Toyota 4Runner with all the off-road fixin's, as does our more practical pal driving a VW Passat.

Dr. Statman, by the way, drives a 27-year-old Toyota station wagon, in part because he wants people to focus on his work more than his ride. But he doesn't judge anyone for expressing a different message with their choice of transportation. (Whew!) Furthermore, he acknowledges that there is a

genuine *emotional* benefit for many who choose that performance Tesla capable of going from 0-to-60 miles per hour in 3.1 seconds.

So in summary, for every financial decision, there are (at least) three lenses of consideration: utilitarian, expressive, and emotional.

Financially Foolish

Let's take it one step further and look at a more extreme example that is universally derided as financially foolish—buying a lottery ticket.

From a utilitarian perspective, it's a sure loser. Almost. Lottery USA suggests the odds of taking home the Mega Millions jackpot are one in 302.6 *million*. So, you're telling me there's a chance…

But from an expressive perspective, some may consider it a sign of aspiration. I know at least one financially independent doctor who considers it an expression of whimsy. "Why not?"

And emotionally, who among us hasn't used the purchase of a lotto ticket simply to imagine what we might do with the proceeds if it were to be the one in 300 million?

(No, I'm not recommending buying lottery tickets or condoning the practice many suggest, with reasonable justification, is a regressive tax. It's just an example.)

But in the eyes of the pure utilitarian, guess what else is financially foolish? Paying off your mortgage. Dr. Statman confessed to having fallen prey to this "foolishness" himself. Yes, every hypothetical calculation would net him a profit between the higher *expected* rate of return in his investment portfolio

relative to the lower rate of interest he'd pay on the mortgage, but he values more highly the expressive and emotional benefits of being debt free.

While you're at it, add to the list of financial follies philanthropic giving (you have less money) and spending money on experiences (you've got nothing to show for it except for your Instagram posts), despite their notable expressive and emotional benefits.

License To Err?

So does that mean we're never in error? That we're off the hook? That we can justify every expenditure, no matter the reason nor the consequences? No, indeed.

What creates an error, Dr. Statman told me, is when someone learns precisely how something works…and then, in recognition of that fact, decides to make a new and different choice. For example, some people give preference to salary dollars over income from bonuses (not withstanding variability)—dividends or interest over capital gains (not withstanding tax implications)—holding individual bonds over bond mutual funds (not withstanding variability in expense ratios)—and yet Statman reminds us that "A Dollar Is A Dollar Is A Dollar. Except In Our Minds."

For example, let's say you prefer a dollar of salary over a dollar of bonus because you believe that there is inherently more value in the former. Then Dr. Statman explains that both of those dollars actually have the same buying power. You're now free to abandon your original belief, count it an error, and step forth into a greater sense of economic awareness.

However, if you acknowledge the sameness in those respective dollars from a utilitarian perspective, but nonetheless choose a preference of salary over

bonus because it feels more stable to you emotionally, you're welcome to forge ahead free of the label of irrationality.

Indeed, behavioral finance 2.0 doesn't offer a license to err—instead it frees us to look at financial decisions from a different perspective (or perspectives), breathing new life into the first generation that, while more self-aware than the staid traditional approach, was unnecessarily judgmental.

(And yes, Dr. Statman would suggest that *Nudge*'s "libertarian paternalism" is needlessly paternalistic. Who are we, after all, to ascribe a higher moral value to saving for retirement than saving for our kids' education, saving the planet, saving souls, or even saving up for that dream vacation or sabbatical?)

So congratulations. You're not as irrational as you may have been led to believe. You're blissfully...normal.

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